LEVERAGE

Legal and technical update: July 2018

Note from the editor

Sharon Hamman (née Teubes), Senior Legal Adviser: Advice and Wealth Management

As Momentum and MMI begin their new financial year with vigour and excitement, the world is revelling in the 2018 FIFA World Cup Russia™ that will come to an end soon. The tournament definitely saw surprises since some of the favourites were kicked out by underdogs. No matter how prepared a team is, the day of the match dictates who the winner is; thus, chance plays a big role.

Thankfully, chance does not have to be a factor when doing financial planning. Financial planning is intended for that exact reason – to remove or limit chance and any unwanted surprises. Instead, it is replaced with peace of mind, consistency and predictability.

In this issue, we focus on capital gains tax (CGT) as it is often an element that clients do not focus on or something that clients are so afraid of that they neglect to make the necessary decisions regarding it. Rone Heymans provides a concise recap of CGT; Annemie Nieman shows that one should not let the fear of paying tax result in financial planning objectives not being met, and Arthie Kander highlights the impact of CGT on death, which underpins that no financial plan is complete without attention being paid to CGT.

Happy reading!

momentum

Overview of capital gains tax (CGT)

By Rone Heymans, Legal adviser: Financial Planning and Advice

The purpose of this article is to provide a high level overview of what Capital Gains Tax (CGT) is, and is intended to serve as a quick refresher or an introduction to the topic.

CGT brings a whole new dimension to a client's financial planning and the impact that it may have on a client's overall financial plan is often underestimated. CGT is not a separate tax. Where there is a taxable capital gain it is included in taxable income and subject to normal income tax; therefore, possibly increasing the taxpayer's marginal tax rate.

As of 1 October 2001, CGT applies to the disposal of a resident's worldwide assets and of a non-resident's immovable property or assets of a permanent establishment situated in SA. CGT applies if the asset is disposed of on or after 1 October 2001, irrespective of whether the asset was acquired before or after that date.

The Eight Schedule to the Income Tax Act provides for four key definitions that are the building blocks when determining whether there is a capital gain or loss, namely:

1. Asset,
2. Disposal,
3. Base cost, and
4. Proceeds.

Is the asset a capital asset?

The definition of an 'asset' is wide and includes property of whatever nature and any right to or interest in such a property. It can include any physical asset or right, shares, unit trusts, endowments, trademarks, copyright, goodwill, gold, silver and platinum coins. Currency (local and foreign) is specifically excluded; therefore, CGT will not apply to cash. The intention of the taxpayer will determine whether the asset was held as a capital asset. Where a capital asset is disposed of, the proceeds received as a consequence will be a capital amount that is subject to CGT.

Was there a 'disposal' or 'deemed disposal' of the capital asset?

A 'disposal' will basically include every situation where there is a change of ownership of an asset; examples are:

- The sale, donation, conversion, scrapping or destruction of an asset,
- The vesting of an interest in a trust asset in a beneficiary, and/or
- The distribution of an asset by a company to a shareholder.

'Deemed disposals' include:

- When a person ceases to be a SA resident;
- When there is a change in the use of an asset; for example, when a capital asset becomes trading stock;
- When an asset is transferred between the funds of a long-term insurer; and/or
- When a person dies.

What are the 'proceeds' or 'deemed proceeds'?

'Proceeds' are the total amount received or accrued to the taxpayer as a result of the disposal. Where assets are disposed of by way of donation or to a connected person at a non-arm's length price or for a consideration not measurable in money it will be deemed to be disposed of at market value. The proceeds will also be deemed to be equal to market value in the case of cessation of residence and on death.

Base cost

Capital gains or capital losses are the difference between the proceeds received as a result of the disposal, less the base cost.

Though the determining of the base cost can become a complex and cumbersome exercise; for the purposes of financial planning, you should keep it as simple as possible. For assets acquired after 1 October 2001, the base cost will be the purchase price paid for the asset plus any allowable expenditure. Holding costs such as repairs, maintenance, rates and taxes usually do not form part of the base cost.

For assets acquired before 1 October 2001, the valuation date value must be determined by applying the market value as at the valuation date. Where the market value on the valuation date is not available, then it is common practice to rely on the 20% of proceeds as the base cost for financial planning purposes. Generally, this will also result in the worst case scenario, which is always the safest route to take when doing financial planning.

Exclusions

There are certain exclusions that a taxpayer is entitled to when determining the taxable capital gain. It can be summarised as follows.

Annual exclusions

The annual exclusion for natural persons and special trusts is R40 000. Upon death, the taxpayer will be entitled to an exclusion of R300 000.

Other exclusions

The disposal of certain other assets is excluded from the application of CGT; for example:

- Personal use assets,
- Lump sum payments from retirement funds,
- Proceeds from pure risk policies without a cash value,
- Proceeds from endowment policies which are not second-hand policies,
- Tax-free investments, and
- Compensation for personal injury claims.

There is also a small business asset exclusion limited to R1 800 000 during a person's lifetime.

Another common exclusion is the primary residence exclusion. Where the proceeds of the disposal of a primary residence is less than R2 000 000, then no CGT is relevant. If the proceeds are more than R2 000 000, then the first R2 000 000 of any capital gain or loss on the sale of a primary residence is disregarded for CGT purposes.

Rollover of capital gains or loss

In some cases, capital gains or losses are rolled over to a future year of assessment; for example, the transfer of assets between spouses as well as certain involuntary disposals such as the loss or destruction of an asset.

Determining Capital Gains Tax (CGT)

Once it is established that the four key elements are present, then CGT can be determined. A taxable capital gain (which will be added to taxable income), or a capital loss (which will be carried forward to the following tax year to be set of against future capital gains) are determined as follows.

Sum of all capital gains and losses received during the tax year

- *The annual exclusion (R40 000 or R300 000)*
= *Aggregate capital gain or loss*
- *Assessed capital loss carried over from previous tax year*
= *Net capital gain or assessed capital loss*
× *Net capital gain by the applicable inclusion rate**
= *Taxable capital gain to be included in taxable income*

* The inclusion rate applicable to natural persons is 40%. In the case of a company, close corporation (CC) or a trust, the inclusion rate is 80%.

Conclusion

CGT is an additional cost that a client has to consider when doing financial planning as it can impact investment returns and liquidity provisions quite substantially. CGT will impact investment choices made as each investment can have a different CGT outcome[1] .

1 For more information on this, see: Nieman, A. 2018. *Investors should avoid Capital Gains Tax (CGT) to their detriment. Leverage, July 2018.*

Investors should NOT avoid Capital Gains Tax (CGT) to their detriment

By Annemie Nieman, Legal Adviser: Financial Planning and Advice

Investors often invest in 'underperforming' funds or tax-inefficient investment vehicles. Despite this, they avoid switching into more suitable funds or investment vehicles as they do not want to trigger capital gains tax (CGT).

The aversion to trigger CGT is exacerbated by the fact that investors do not really understand the workings of CGT. They think that their CGT liability applies to all returns, when it applies only to realised gains and not to interest earned or dividends declared. Further, they think that they will be liable for CGT on the entire amount switched when in actual fact they are switching nothing more than their own capital. In reality, their CGT liability is often far less than perceived.

These misperceptions can be explained by way of simple examples:

Example 1

Adam invested in unit trusts:

- R300 000 in a money market fund and R700 000 in an equity fund.
- Four years later there is R411 178 in the money market fund and R1 024 870 in the equity fund.
- He decides to switch R400 000
- Marginal rate: 45%
- Capital gains exclusion: R40 000

If R400 000 is switched from the money market fund, then no CGT will be payable. He will be switching his capital and the after tax interest (he would have paid income tax on the interest earned annually insofar it exceeded the exemption); therefore, there will be no realised gains.

If R400 000 is switched from the equity fund, he would be switching 39.03% of the total equity fund; that is, 39.03% of the initial capital of R700 000 and 39.03% of the gain of R324 870.

Note: He cannot switch only gains, as it cannot be separated from the units (initial capital) on which it was earned.

Therefore, R273 205 (39.03% of R700 000) will represent initial capital (base cost) and R126 795 (39.03% of R324 870) realised capital gains.

CGT will only apply to the R126 795 realised gains, resulting in a CGT liability of only R15 623.

Continued on next page

Continued from previous page

Example 2

Belinda invested in a unit trust fund:

- Base cost: R1 000 000
- Market value: R1 385 859
- Average return: 8.5% per year
- Marginal rate: 36% (effective CGT rate of 14.4% [40% x 36%])
- Funds needed at retirement in 15 years.
- She needs a return of 12% per year to reach her retirement goals, but is reluctant to switch to a more suitable fund as she does not want to pay CGT of R55 563 (R1 385 859 – R1 000 000) x 40% x 36%).
- Ignore capital gains exclusion.

	Remaining in the underperforming fund (8.5%)	Switching to better performing fund (12%)
Market value	R1 385 859	R1 330 296 (R1 385 859 – R55 563)
Base cost	R1 000 000	R1 330 296
Projected value after 15 years	R4 711 563	R7 281 462
Total capital gain	R3 711 563 (R4 711 563 – R1 000 000)	R5 951 166 (R7 281 462– R1 330 296)
Capital Gains Tax (CGT)	R534 465 (R3 711 563 x 14.4%)	R856 968 (R5 951 166 x 14.4%)
Net investment after tax	**R4 177 098** (R4 711 563 – R534 465)	**R6 424 494** (R7 281 462 – R856 968)

Example 3

Trust ABC has a unit trust portfolio –

- Base cost - R3 mil
- Market value - R5 mil
- Average return - 13% per year
- Marginal rate - 45%
- No distribution to beneficiaries and no funds required for another 10 years
- The trustees are reluctant to switch to a more tax efficient sinking fund because of the CGT it would trigger, which is equal to R 720 000 ((R5 mil – R3 mil) x 80% x 45%)

	Remaining invested in the unit trust	Switching to a sinking fund
Market value	R5 000 000	**R4 280 000** **(R5 000 000 – R720 000)**
Base cost	R3 000 000	R4 280 000
Projected value after 10 years	R16 972 836	R14 528 748
Total capital gain	**R13 972 836** **(R16 972 836 – R3 000 000)**	R10 248 748 (R14 528 748 – R4 280 000)
Capital Gains Tax (CGT)	R5 030 221 (R13 972 836 x 36%)	R1 229 847 (R10 248 748 x 12%)
Net investment after tax	R11 942 615 (R16 972 836 – R5 030 221)	R13 298 901 (R14 528 748 – R1 229 847)

Note - The effective CGT rate in an endowment/sinking fund policy owned by a trust with natural persons as beneficiaries, is 40% x 30% = 12%,

Investors who remain in unsuitable funds or investment vehicles are "shooting themselves in the foot." Twice! They are not ridding themselves of their CGT liability, but they are only ensuring a CGT liability on underperforming returns or at a higher effective rate.

Investors shouldn't reject the idea of switching to more suitable funds or more tax efficient investment vehicles simply because CGT will be triggered. Instead, a proper analysis should be done of what it would cost them to switch compared to what it would cost them if they didn't. Quite often they stand to gain more from a switch than they stand to lose.

Capital Gains Tax (CGT) implications on death

By Arthie Kander, Senior Fiduciary Specialist, Momentum Trust

It became apparent post-2001, with the introduction of Capital Gains Tax (CGT) that a mismatch existed between the application of the Income Tax Act (ITA) and the Eight Schedule (which relates to CGT) on death of an individual. Anomalies and interpretational difficulties permeated themselves, such as in terms of Paragraph 40 of the Eighth Schedule to the ITA, capital gains and losses were recognised in the hands of the deceased, while in terms of Section 25, any income received or accrued and expenses incurred by the deceased estate for the benefit of ascertained heirs and legatees, were deemed to be incurred by those heirs and legatees. In an effort to align all rules applying in respect of deceased persons and deceased estates, unified rules in terms of Section 9HA of the ITA now apply in principle to gains and losses of whatever nature triggered on death, with certain exceptions being preserved.

Section 9HA replaced Paragraph 40 and came into effect on 1 March 2016. This provision deems a deceased person to have disposed of their assets for tax purposes, for an amount equal to its market value on the date of death, for the difference between the market value of all their assets at date of their death and their base cost, with the exception of assets accruing to the surviving spouse and approved public benefit organisations and qualifying long-term insurance policies and fund benefits.

Where assets are inherited by the spouse of a resident deceased, that deceased person is deemed to have disposed of their assets for an amount equal to the base cost of the assets, on the date of that person's death. No CGT liability will arise where assets are bequeathed to a spouse. Assets inherited by an heir or legatee (other than a spouse), are treated as disposals at market value. Bequests to heirs and legatees could result in a capital gains liability in the hand of the deceased estate. In circumstances where the deceased estate has insufficient liquidity to pay CGT liability, the executor may allow an heir to acquire the asset from the estate provided they accept whole or part of the CGT liability. In such circumstances, the sale of that asset is prevented in order to pay the CGT liability. Such CGT liability together with interest must be paid within three years of the executor obtaining permission to distribute the asset and any CGT liability to such heir.

When a resident natural person dies, they will be liable for CGT on the disposal of assets wherever they are situated in the world. Net capital gains must be included in the taxpayer's taxable income while net losses can be carried forward to the next tax period.

There are three taxpayers involved who could be liable for CGT, they are as follows.

1. The deceased person in the year of death: May be liable for CGT on the growth on the value of the assets (that is, the market value of the asset on the date of death, less the base cost of the asset). The deceased person will be entitled to a CGT exclusion of R300 000 in the year of death (an increase from the annual R40 000 exclusion). All the other exclusions pertaining to CGT will also apply.
2. The deceased's estate: The proceeds resulting from deemed disposal is regarded as the market value of the assets in the estate. The deceased estate will be treated as having acquired those assets for a base cost equal to that market value. Should the executor sell an asset at greater than market value then CGT may be levied on the gain earned in respect of the sale. The executor of the estate must pay this CGT from the estate.
3. The heirs and legatees of the deceased's estate: The person receiving the asset from the estate is deemed to have acquired the assets inherited at the same market value as the estate plus any expenditure incurred and will be treated as part of the base cost of the asset to the heir. No further CGT will be payable when an heir receives an asset from the deceased estate.

Death triggers a CGT event for a person and their estate. CGT is an added burden to the liquidity of a client's estate. It is fundamental that estate planners assess the impact of tax consequences on bequests made and determine the liquidity needs in such circumstance on death.

About Leverage

Momentum Leverage is prepared by the Momentum Legal Advisers: Financial Planning and Fiduciary Specialists from Momentum Fiduciary Services. For financial advisers, please contact your legal adviser or fiduciary specialist should you have any questions. For clients, please contact your financial adviser should you have any questions.